CENTRUL ANALITIC

Expert Grup

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Summary

In order to recover failings existent in the **business environment**, in March the Government adopted a program for the implementation of the Action Plan EU – Moldova for 2007. The document includes a series of important measures for improving the conditions for business. The Parliament decided to establish a Center for legislative harmonization and the National Competition Agency. The last one is of big importance, having in mind Moldova's has long failed in ensuring an honest competition. Nevertheless, to ensure the functionality of these structures, there is a need for more consistent measures than a simple appointment of directors. In March, an important set of laws for modernizing the MSTQ infrastructure (law on the technical regulation, general security of products and the amendment of the law on standardization) was adopted. This legislative action was expected by the Moldovan business and consumers communities for a long time.

Despite the government's cheery rhetoric, the **industry** recession only deepened in February. After a January fall of almost 10%, in February the sector shrank with other 17%; the total output produced in January-February reached 3.3 billion lei. The output's decrease stemmed mainly from the strong decline in alcoholic production. The negative evolution of the alcoholic drinks industry had an impact upon the glass production branch. The decrease of the meat processing branch by 5% in January 2007 was plentifully compensated in February, and the total growth marked up +5%. One of the factors causing this positive change was the optimistic expectations of producers regarding the re-launching of meat exports to Russia and Ukraine. As we forecasted in previous BER editions, the recession of the industry of tobacco products only intensified in February (-36%). On the contrary, the textile industry inspires much more optimism than before.

The situation in the **agriculture** worsened. The spring agricultural works in the viticulture sector are late because of the uncertainties in the winemaking sector and the unpaid loans of the wine producers. At the same time, the authorities continue to follow false political objectives, such as land consolidation, and refuse to dialog openly and argumentatively about the policies of agriculture subvention.

Services are the sector that compensated in the first quarter the agriculture's and industry's involutions. The tendency for consumption remains on high levels, spurred by increasing salaries (in real terms) and the foreign financial injections. The services-providing companies bank on these consumption inclinations and open new retail chains, develop the telecommunication services etc. Moreover, starting with the second half of 2006, the services rendered to enterprises, namely transport services, seem to have recovered. The volume of goods transported in January-February 2007 exceeded by 8% the same indicator for 2006.

The consumer **prices** rose moderately in February (+0.7%), mainly due to the weakness of the seasonal factors which in previous years had determined the increases in food prices. However, the boost of industrial prices (+19%) is worrisome. This could signal the accumulation of inflationary pressures in the economic system, which finally (most probable after general local elections) will have to unleash.

On the **labor market**, the rate of the wage rise slowed down in February. Actually, comparing to January 2007, in February the real salary decreased by 5%, although the salaries' rise still remains higher than in February 2006. If in January only the employees in the beverages industry and education suffered from the declining real purchasing power of their salaries, then in February the employees in the health and social protection sectors added to them. Comparing to 2006, in 2007 the most radical wage decline has so far been in the food industry (-9.5%). Extremely alarming is the reduction of the number of employees in economy by 25 thousand persons; a tendency stemmed from the liquidation of workplaces in the winemaking sector.

Despite the difficulties in the industry and agriculture, the public budget continues to collect high revenues because of the rapidly increasing consumption (+33% as compared to January - February 2006), although the expenditures are executed less promptly. The merits of the Ministry of Finance in executing the revenues are indisputable, as well as its failures in collecting the huge historical debts (1.2 billion lei, 70% of them are fiscal debts). However, the responsibility for uncollected debts lies, to a large extent, rather on the governance in general than on the Ministry of Finance as an executor. As some decisions adopted in March show (the conversion of some fiscal debts in shares, the buyback and the handover of an amusement center to a theater) the Government and the Parliament encourage by their own decisions the fiscal indiscipline in the public sector and earmark the limited financial resources to actions which cannot be considered priority for a poor country.

At the moment, in the **monetary sector** have not occurred any essential changes. The National Bank kept

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unchanged the rates on its monetary policy tools, relying, probably, on the encouraging evolutions of the consumer prices. Nevertheless, the boost of industrial prices in February should be interpreted as a warning that in future would force the NBM to harden the policies regarding credits. But, the objective to comply with the inflationary target is constantly undermined by strong currency inflows into economy, carried out by both emigrants and the investors and international financial institutions.

Despite troubles with frozen loans in the plagued wine-sector, the **banking system** continues to develop fast. Indices of available liquidity improved in the first two months, returns on equity and assets are at high levels, while liquidity indices exceed minimum threshold established by the NBM. The only worrisome development is consolidation of foreign currency deposits (49% of total in February 2007 to 39% in February 2006). In February-March interest on credits fell, as commercial banks probably understood that they exaggerated previously with the deposit offers. Indeed, it is not rational to establish high interests on monetary resources that end in the banking system even if interests fall.

Financial markets were characterized by falling interests on T-bonds as banks pursue investment of available resources in safe assets in order to offset bad loans in wine sector. Big inflows of foreign currency on behalf of individuals and substantial incoming foreign investments determined appreciation of national currency against the US dollar. On the 1st March US dollar equaled 12.8040 MDL, while on the 31st March it declined to 12,5414 MDL. On the insurance market, some important changes are in place. After Law on insurance was re-voted by the Parliament in March, insurance companies will have to increase social capital to 4 mln. MDL in 2007, and afterwards up to 15 mln. In March stock market indicator showed a moderate cooling. Nevertheless, its capitalization remains quite high due to equities issued by the commercial banks.

Moldova's **foreign trade** its quality slide in the beginning of 2007. In February trade deficit reached 296.8 mln. US dollars, almost doubling comparing to February, 2006. Against the background of a modest rise in exports (5% y/y 02/07 to 02/06), imports grew with 43.0%. In the wake of Romania's accession, the EU became our most important trade partner. Exports to Romania grew mostly due to significant growth in metal supplies (12.3% of total of exports) and other goods (e.g., sunflower oils, +16.9%). Contrasting positive developments connected to resumption of meat, fruit and vegetable exports, resumption of wine-exports to Russia remains highly uncertain. Wine exporters have had some more reasons to worry in the first months of 2007, as a result of "telephone" ban on raw wine exports by MoldovaVin. Raw wine exports served as saving straw, withdrawn cynically by bureaucrats not thinking in terms of economic policy efficiency. Recently, the illegal ban of raw wine exports was revoked.

By the end of March global oil price (WTI brand) fluctuated around $66/barrel. In February-March 2007 wheat prices were chiefly determined by downward developments on American markets, while prices in Europe moved upwards. Dollar depreciated against the euro in March, the trend felt in Leu exchange rate against these currencies. Weak dollar was mainly determined by slack in economic indicators and need for correcting of imbalances in US economy.

Moldova's **trade partners** economies continued to grow. Russian economy experienced robust economic growth in January-February 2007 (+8.4%). The Ukrainian economy followed the same growth path despite growing political tensions between the Government and Presidency. In the wake of European accession, Romanian economy continues to grow fast, a development which is favorable to Moldovan exporters. EU economies can also boast a perky growth. However, many analysts anticipate a moderate deceleration of the economic growth rate, caused by increases in VAT rate in Germany and Italy, strengthening euro against the US dollar and cooling of American economy, main destination of European exports.

Business environment

In the first quarter of the 2007 year a series of programs, governmental strategies and legislative acts, which will influence the business environment in a short-term, were adopted. On February 3, 2007 the Government adopted the Program of measures for the implementation of the Action Plan EU - Moldova[1], by establishing *inter alia* measures for enhancing the functioning of economic system in accordance with the Action Plan's provisions. Unfortunately, the adequate implementation of the Action Plan is hindered by the deficit of high qualified public servants, lack of a clear priority and coordination of the implementation process, and the existence of an institutional rivalry, useless in the case of such a national important document.

On February 21, 2007 the Government adopted a decision concerning the establishment of a National Center for harmonization of legislation, with the mission to adjust the national legislation to the European Union's one. Taking into account the complexity of European economic and trade legislation, it is obvious that the Center has to be endowed with high-qualified human resources, and has to start collaboration with specialized European institutions and those from neighbor states. It is noteworthy the adoption on February 1, 2007 of the Strategy for reforming the state normative framework of the entrepreneurship activity. On March 22, the Parliament set up a special Commission for optimizing the legislative framework regulating the entrepreneurship activity. However, the reform progress is undermined by inertia of ministries and other central authorities which still have not presented any analysis of the impact of legislation on the entrepreneurship activity in their areas of responsibility.

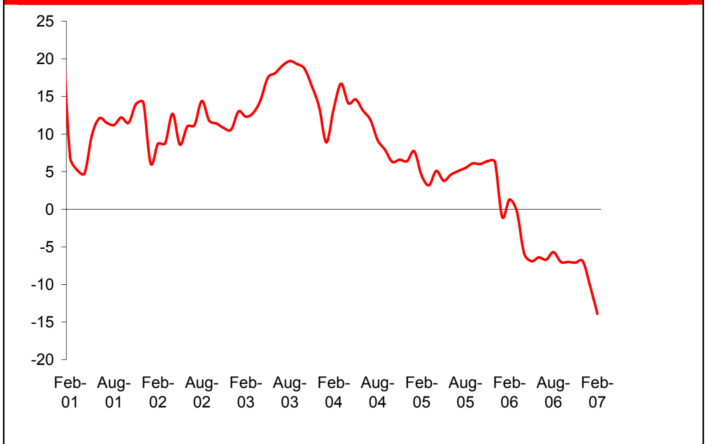
In March, was finally published the decision on establishing the National Competition Agency (NCA) [2], the Parliament appointing the Agency's directors and deputy directors. Obviously, the directors' appointment is not sufficient for Agency to become functional. The short-term priority is to endow the Agency with human, financial and technical resources necessary for its effective functioning and to create the normative instruments to be applied by NCA. A powerful agency for protecting the competition is not only an objective economic necessity, but a condition stipulated explicitly in the Action Plan EU - Moldova.

In March several important laws regulating the management quality infrastructure were published. They had been waited for a long time by the business and consumers' in Moldova. Among these laws, we note the law on the activity of technical regulation, which will enter in force in 6 months. By passing this law, the legislators declared as goal the removal of all technical barriers to trade.[3]. The same legislative package comprises a series of significant amendments to the law on standardization.[4]. Other important news is the law on the general security of products that presumes a series of obligations, specific competencies and responsibilities in the field of products' security.

Industry

Although in January it seemed that the industry reached its trough, in February recession only stepped up (Figure 1). After a fall of almost 10% in January, in February the sector shrank with other 17%, the total output produced in first two months reckoning 3.3 billion lei. The output's decrease stemmed mainly from the strong decline in alcoholic production. In February, the alcoholic drinks industry negative repercussions spread into the glass production branch.

Figure 1 Industrial output growth, %



Sourse: NBS

A year after the halt of wine exports to Russian Federation, the Moldovan industry registers important structural changes.

Besides the direct consequences, the economic and social effect of these structural changes will be felt in long run. The most important structural changes are related with the decrease of the wine-making sector's weight in the total industrial output from 20.3% in 2006 to 5.9% in 2007, and with the increasing share of the food,

[1] Government Decision no. 113, February 3, 2007.
[2] Parliament Decision no. 21-XVI, February 16, 2007.
[3] The Law no.420-XVI, December 22, 2006.
[4] The Law no. 1016-IV, March 6, 2007 for amending and completing the Law no.590-XIII of 22 September 1995 on standardization.

non-alcoholic beverages and light industry production (Table 1).

Table 1 The structure of industrial output, January – February, %

	2006	2007
Extractive industry production	0.5	1.4
Food production and non-alcoholic drinks	15.4	25.1
Alcoholic products	20.3	5.9
Tobacco products	2.1	1.8
Textiles	2.4	4.1
Clothing, footwear and bordering branches	2.9	17.7
Paper and carton products	1.8	2.4
Construction materials	6.4	10.6
Machines and equipments	1.5	1.6
Electricity	11.0	12.8
Thermal energy	3.7	4.9
Other products	32.0	11.7

Sources: NBS and EG calculations

In the first two months the extractive industry had a very good evolution (although this sub-sector is relatively not important, accounting for 1.4% of total industrial output). Other important sub-sector, the energy dropped by 8%, but this was caused mainly by a lower demand for energy because of favorable weather conditions. The reduction of local electricity production was also favored by the imports of cheaper electricity from Ukraine, while the production costs on the internal market rose.

Although the decrease of energy production cut back 1.4 percentage points from the industrial output growth, it is obvious that the main source of the industrial recession resides in the processing industry. If in January the production of the processing industry felt by 28%, then in the first two months the cumulative result was already -37%.

As compared to January, in February some important changes in the dynamics of the processing industry happened. The decrease by 5% of the meat processing branch in January 2007 was plentifully compensated in February, and the total growth marked up +5%. One of the factors causing this positive change was the optimistic expectations of the producers regarding the re-launching of meat exports to Russia and Ukraine (effectively were resumed in March). Although not all enterprises enjoy the right to resume meat exports, we consider that during next months the growth of this branch will step up.

As EXPERT-GRUP anticipated in previous BER editions the recession of the industry of tobacco products has only intensified. The indicator of -23% in January felt even more during the January-February period, to -36%. On the contrary, the textile industry inspires much more optimism, mainly because of the intensification of the carpet production growth (+22% in the first two months, comparing to 12% in January 2007). Nevertheless, the growth of apparel production slightly slowed down, from +5% in January to +2% in January-February, conditioned probably by warm weather. As shows the reports published in February-March by the joint-stock companies from the textile industry, the economic and financial expectations of the manufacturers are extremely positive, while the integration of these companies in the European value networks deepens.

The strong expansion registered by the chemical industry during the first two months of 2007 is half explained by the fulminating growth of the pharmaceutical production (+47%). After the introduction of VAT on imports of medicines in January 2005, local producers are now protected from foreign competition. We hope that this “pause” will be used efficiently for enhancing the competitiveness through quality. The boom in the constructions sector encouraged a significant growth of the paint and varnish production. The third chemical branch – the cosmetics production – has registered a moderate recession for eight months in a row. In comparison with January-February 2006, the local production of perfumes and cosmetics decreased by 3% during the same period of 2007. EXPERT-GRUP deems that in the forthcoming months the branch’s recession will be followed by a moderate growth. However, in the long-run its perspectives will depend on industry’s capacity to compete with the avalanche of imported products.

The industry of machinery and equipments seems to be in a better position in 2007 than in the first months of the previous year, with a growth rate +7%, as compared to -32% in 2006. A more striking growth is impeded by difficulties faced by the pumps and hydraulic equipment producers.

The general public’s and wine producers’ expectations concerning the re-launching of wine exports to Russian Federation were not justified in March neither. The bureaucratic and technical stalemates seem to have behind some political factors too. This let us think that wine producers have to consider as primary strategy the diversification of the external markets and to leave behind the hopes about the re-opening of Russian market. The most encouraging evolution for wine producers will be the denouncement of the “Moldova-Vin” “telephonic” interdiction of the bulk wine exports

Agriculture

The situation in the wine-making sector generated serious problems for the winegrowers, which delay the beginning of spring agricultural works due to the uncertainties linked with the sale of future grapes production. The winemakers have excessive wine stocks and only few will venture to purchase grapes of the 2007 harvest. Moreover, according to some estimations, the winemakers still owe the viticulture sector around 200 million lei for the grapes purchased in 2006. Taking into account the current financial situation of wine producers it is unlikely that in the near future they will pay the outstanding debts.

An analysis of the political rhetoric during the February-March period shows that the government keeps on promoting a false priority of the land consolidation. EXPERT-GRUP thinks that this agricultural policy' approach by no means should be considered a priority. The land consolidation should result only from a natural development and modernization of the agricultural sector (which, anyway, already happens in a natural way through economic instruments). Actually, a government that shares a left ideology should follow that the land would not become excessively concentrated in the hands of new "latifundistas".

The objective of land consolidation transpires also, in a disguised manner, in the Regulation on administrating the means of the fund supporting the establishment of the wine plantations, adopted by the Parliament in March 2007 [5]. The new Regulation stipulates that compensations (measuring up 25 thousand lei for 1 ha of useful area of grapes plus certain conditioned aids) will be offered to one or many holders only for varieties planted on a compact area of 5 ha (and 1 ha for varieties of table grapes).

Previously, the parliamentarian opposition proposed to low the threshold for offering subsidies for planting grapevines to 0.5 ha. We consider that the government rejected the motion of opposition for the simple reason that it was put forward by opposition, not because of its irrelevance from the economic efficiency view.

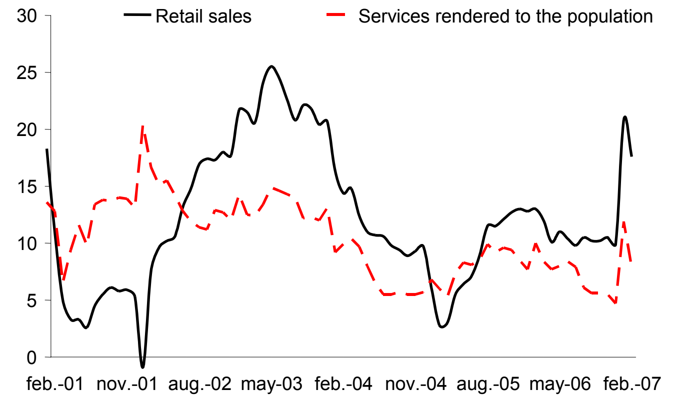
Services

If to believe the official statistical data, the services sector has showed from the beginning of the year a positive dynamics much over previous pundits' expectations. The GDP real economic growth in the first quarter will be ensured exclusively by this sector. Thus, in the first two months the volume of retail sales grew in real terms by 17.6%, and the volume of services rendered to the population - by 7.8%. The growth was extremely robust in January, but in February the consumption pace slowed down a little (Figure 2).

[5] Parliament Decision no-XVI, February 9 2007.

The very high growth rate of consumption is reflected in the powerful rise of imports (see **Foreign Trade**). It is noteworthy that in March the competition in the retail sector intensified even more after the Ukrainian retail chain „Fourchette" opened its first store in Chisinau. According to available information, other few local and foreign retail chains take steps to open stores in different niches of the retail segment.

Figure 2 Growth of retail sales and services rendered to the population, %



Source: NBS

The telecommunications sector has cheered up since the beginning of March when Moldtelecom entered the market under the "Unite" brand. Although the new player entered the market less spectacularly than the consumers expected, it is likely that the operator will compensate the initial deficit of image by substantial investments into infrastructure and by rendering cheaper services. In the fist half of the year it is also expected the launching of a new mobile communication network by the Moldavian - Cypriot company „Eventis-Mobile". The market dilution and image rearrangements carry out in conditions when the mobile communication market still displays a great growth potential (estimated by National Agency for Telecommunications and Informatics Regulation at 31% for 2007).

In March the telecommunication sector, in particular the company „SunCommunications", received a large foreign investment (8 million USD) from the European Bank for Reconstructions and Development. The financial injection will favor the geographical expansion and qualitative improvement of the rendered services. On the other hand, such a substantial investment will impel other important companies to find investments for modernization and expansion if they want to remain competitive in the long run.

From the beginning of 2007 the transport services have shown a moderate recovery following a recession of

4.4% in 2006. The quantity of goods transported during January-February 2007 surpassed by 8% the same indicator for 2006, while the number of passengers did not basically change. In the segment of goods transportation, the increase was almost integrally ensured by the private auto transportation, where the volume of rendered services rose by 55%. The problems of transiting Transnistrian region and Ukraine, appeared in 2006 in the railroad system were not completely solved, thus the railroad transportation of goods did not registered any positive dynamics. The cargo and passengers air transportation, despite its insignificant weight in the total amount of services, shows a great growth potential. For its complete use, Moldova needs significant investments for modernizing the existent airport infrastructure (Balti, Cahul and Marculesti airports).

Constructions

The National Bureau of Statistics changed the frequency of publishing the data about the enterprise activities, which has complicated the operative analyses. If previously the data were published monthly, starting with 2007 they are available only on the quarterly basis. However, some alternative data (evolution of the number of constructions license, the number of previous commands and the production of construction materials) and empirical observations suggest that in the first quarter of 2007 the activity in this sector remained very intense.

At the same time, according to the assessments by real estate agencies, the demand for apartments, offices and industrial spaces grew marginally in the first quarter. The price for apartments oscillated in January-March between 780 and 800/m^2 USD, and the current and prospective demand is mainly oriented to the 2 rooms-apartments.

Prices

The monthly inflation rate in February was 0.7% that is a great performance comparing to the inflation rate of 1.4% in February 2006. The cumulative inflation rate for January-February was 1.6% (as compared to 3/3% in January-February 2006). This seems to fit the monthly schedule necessary to comply with inflationary target of10% set by the National Bank of Moldova (NBM) for 2007.

At the same time, we cannot turn blind eye to sharp rise (19.4% in February); such rise of prices has not happen for a long time. EXPERT-GRUP forecasted these inflationary risks in the previous BER editions. The boost of industrial prices represents a clear symptom of an increase of production costs and a sign that next months the inflationary pressures from the production sector could spread to the consumer prices.

Analyzing the prices by the categories of products and services, the most stable were the prices for food (+0.4%). The price for non-food goods rose by 0.6% and for services by 1.3%. A greater rise of price for services was obstructed by the administrative resistance of the government due the upcoming general local elections.

Table 2. Monthly inflation rates, %

	January 2007	February 2007
The index of the consumer prices	0.9	0.7
Food	1.4	0.4
Non-food goods	0.8	0.2
Services	0.2	1.3
The index of industrial prices	1.3	19.4

Sources: NBS and NBM

Like in January, the factors of seasonal rise of prices for several foods (vegetables, potatoes and fruits) weakened in February, thus compensating the rise of prices for other products. Therefore, the rise of prices for footwear, clothing, flour and medicine has accelerated in 2007. A temporary blip in oil prices was another factor mollifying the inflationary risks.

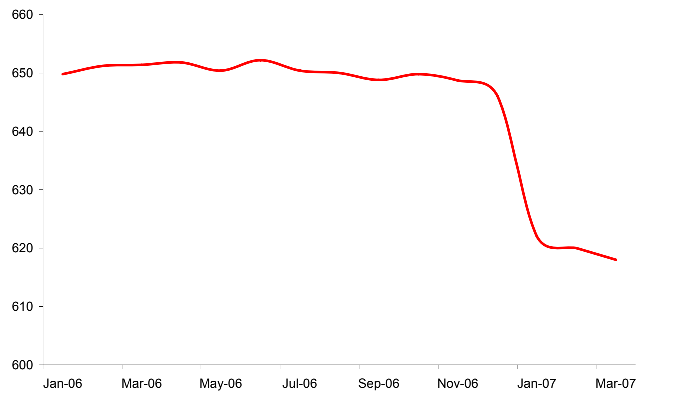
After the February 2007 decisions of the National Agency for Energy Regulation (NAER) and local councils the prices for centrally-provided natural gas and water have risen. Similarly to the previous year, the prices on public utilities have risen slighter due to two factors. Firstly, the mild winter lowered demand for energy. Secondly, the government opposition to a rapid adjustment of the tariffs to the real production costs. However, these factors do not soothe the manifestation of inflationary pressures in the economy; they only postpone it.

Labor market

The February evolutions on the labor market differed from the January ones. It is noteworthy that the real salary decreased by 5% comparing to January 2007. If to compare the annualized real salaries (February 2007 relative to February 2006), it can be noticed that in February the average salary increased by 6.5%, as compared to 11% in January.

Slower wage growth in February is explained by the decline of real annualized salaries in several branches. If in January only the employees from the beverages industry and education suffered from the declining real purchasing power of their salaries, then in February this phenomenon also affected the employees from the health, social protection and other areas. In 2007 the most drastic decline in salaries was observed in the food industry (-9.5%). At the same time, the real salaries in the beverages industry dropped by 3.8%, in education – by 6.6%, in the health and social protection systems – by 2.9%. Such erosion of the salaries purchasing power is socially dangerous. It is noteworthy that the reduction came after an increase of salaries by 12% (in real terms) in January. It is difficult to explain this dynamics when the main branches of food industry maintained growth trend throughout this period.

Figure 3 Trends in number of employees at the enterprises with over-20 employees, thousand



Source: NBS

The decline in the number of employed, which fell by nearly 25,000 only in January (Figure 3). Actually, the phenomenon of jobs' closing at big enterprises has been noticed starting with 2006. The cuts are operated especially by companies from the winemaking industry which currently pass through the most acute recession in the last 16 years (see **Industry**).

Budget

In January-February 2007 the global public budget revenues rose by 13% comparing to the planned level and by 33% comparing to January-February 2006. The VAT remains the only "air bag" between the public budget and the real sector, which has now a hard time.

During the first two months, the majority of budgetary revenues lines were executed over the planned level, except the revenues from the special means of the public institutions (-26%). The last happened due to the normative reform and the revision of the governmental structure. The execution of revenues improved slightly as compared to January, although still remains under the planned 70% target. The technical and systemic causes of this situation were showed in BER-17.

Table 3 The dynamics of the national public budget

	Planned M1-M2/07	Executed M1-M2/07	Executed M1-M2/06
Global revenues, MDL million	2477.3	2786.7	2075.7
Including, revenues from VAT, million MDL	886.2	917.3	647.8
Including, taxes on income coming from business activity	133.3	194.0	123.6
Global expenditures, MDL million	3935.1	2705.2	2004.4

Sources: Ministry of Finance

In March the Government highly appreciated the activity of the Ministry of Finance in 2006[6]. In the respective decision Government mentioned the ministry's accomplishments in improving the management of public finances, in consolidating the Framework for Medium-Term Expenditures and in modernizing the legislative framework (by elaborating new versions of the laws on accounting, auditing and insurance, the law on the state debt). The main Ministry's unachieved target continues to be the recovery of the economic agents' historical debts to the public budget (1.2 billion lei), and 70% of them are composed of arrears, penalties and fiscal fines.

At the same time, for recovering the arrears, the government has to convey clear signals to the fiscal debtors such that to impose a financial discipline and the payment of the fiscal arrears. Contrary to this requirement, in Moldova continue to be adopted normative and legislative acts undermining the financial discipline. The most recent case is the decision to convert into state shares the debts of the Joint-stock Company "Combinatul de Produse Cerealiere din Chişinău" (7 million lei arrears to the state budget and 55 million lei arrears for reimbursing the foreign loans)[7]

Even more, despite the deficit of financial means and the rhetorical adherence to the development priorities of economy and poverty reduction, the Government continues to spend money for actions not at all a priority. The most meaningful example is the redemption by the Ministry of Culture and Tourism (in unclear conditions) of the Amusement Center „Moscova" and its handover for utilization to the theater „Eugen Ionesco". We support the development of theatres and cultural life in Moldova, but we do not consider this to be a main present priority for spending public money.

Money

The first trimester of 2007 did not bring any significant changes in the monetary and foreign exchange policy of

[6] Government Decision no.315, March 19, 2007.
[7] The Law no.58-XVI, March 15, 2007.

the National Bank of Moldova (NBM). When analyzing only the inflation of consumer prices, it seems that it fits the limits for "eyeing" the inflationary target of 10% established by the NBM for 2007; thus there should have been no reasons for changing the monetary policy tools.

Due to the strong rise in industrial prices (see **Prices**), however, the inflationary risks vividly transpired. EXPERT-GRUP thinks that these processes have to be considered by the NBM, and probably in the next months the Bank would revise the rates of its monetary policy tools. Especially, it is likely the marginal growth of REPO rate from 14.5% to 15.0-15.5% and the intensification of monetary sterilization operations by the NBM Certificates and by attracting deposits.

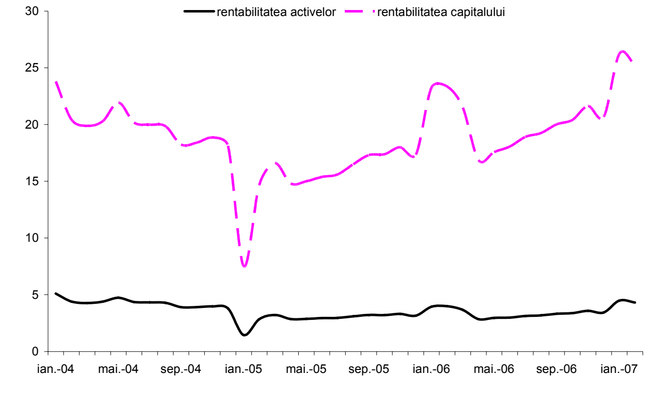
In 2007 the BNM is almost absent on the foreign exchange market; the net purchases of foreign currency in the first quarter were almost 4.2 million USD. The foreign currency inflows to the economy are very strong and produce an appreciation of the national currency. Taking in consideration these inflows, the NBM task for shoring the inflationary risks in the economy becomes more complicated, since the Bank has to oppose the exporters' pressures which aim at a competitive depreciation of the Moldovan Leu. But the exporters have to understand that the competitiveness generated by a weak national currency is illusory and not efficient in the long term; the only worthy model to be followed is the competitiveness through efficiency and quality.

Banking system

The Moldavian banking system has continued to develop rapidly despite the problems with "frozen" credits in the winemaking sector. In January-February 2007 the indices of the capital sufficiency improved. At the same time, the return on equity and assets indices reached historical highs (Figure 4), and the liquidity indices exceeded the norms established by the NBM. The only evolution causing doubt is the growing weight of deposits in foreign currency (49% in February 2007 as compared to 39% in February 2006).

As we mentioned in the previous edition (BER-17), the growth potential of the interest rates in January-February 2007 was not high. Thus, since in January the interest for credits in MDL rose by 0.29 percentage points, in February the interest rate felt almost to the level registered in February 2006 (18.32%). In February 2007 the foreign currency credits decreased also by 1 percentage point to the rate of 11.02%. In January-February the total credit in the banking system increased slightly, only by 3%

Figure 4 Trends in indices of banking profitability

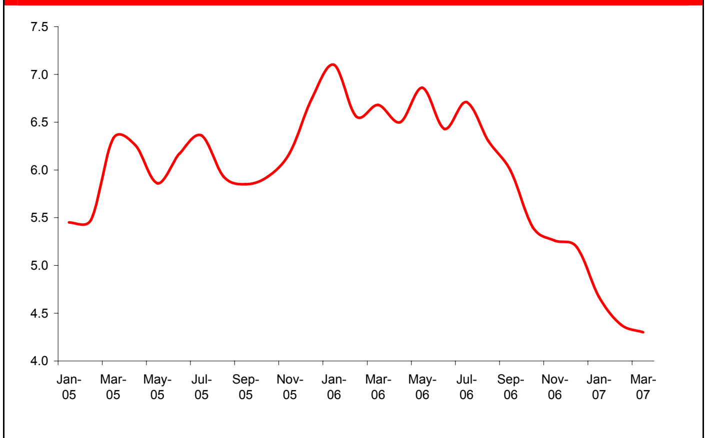


Source: NBM

The dynamics of the interest on credits was to a large extent influenced by the devaluation of the bank-drawn resources. Especially, the interest on deposits in MDL dropped from 14.03% in January to 13.94% in February, and on foreign currency deposits from 5.86% to 5.58%. In January-February, the total deposits in the banking system grew by 8%. Considering some available monetary indicators (the perceived interest rate), EXPERT-GRUP estimated that in March the interest rate on deposits in MDL remained slightly under the level of 14%.

Other factor causing the credits devaluation is the approaching "season" of active crediting. In order to catch more clients, the banks seem to give up, for a short time, to a larger part of their profits. This thing was proved by the evolution of the banks' interest spread (Figure 5), in the situation when other factors of efficiency favored the amelioration of the banking profitability.

Figure 5 Evolution of the banking interest spread



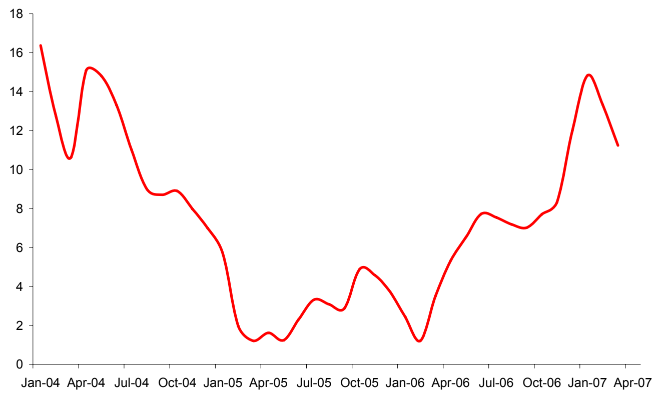
Source: BNM

As previously mentioned, the resources drawn by banks increased faster than the offered credits. Namely, the banks do not have a liquidity deficit. At this moment, a part of resources are invested in T-bonds (see **Financial Markets**), but in future, along with the decreasing interest on bonds, the banks should find more profitable financial investments.

Financial markets

Following a vigorous growth during March 2006 - January 2007, the interest rate on bonds traded on the primary market decreased in February-March 2007 (Figure 6). Therefore, if at the auction of 2 January 2007 the weighted average interest rate on T-bonds with maturity of 91 days was 14.33%, then at the auction of 27 February it felt to 11.72%. At the auction of 13 March 2007 this indicator reached the level of 11.00%, showing thereafter a weak rising tendency.

Figure 6 Evolution of the average interest rate on T-bonds, %



Source: NBM

Maintaining recent trend, the banks' demand at the last auctions surpassed considerably the supply by the Ministry of Finance (by about 50% at the last auction in March 2007). The persistence of this disparity during next months will favor the Ministry of Finance to acquire the public debt under more gainful conditions.

The most likely, in the next future, the banks will remained interested in investing the available resources in state securities. The main factors which explain the banks' interest for state securities were the deficit of any alternative for banking investment, constant inflow of money to the banking system (see **Banking System**) and maybe, the most important, the need to offset by risky-reduced assets the uncertain or menacing credits offered to the wine producers.

As a result of large inflows of foreign currency from individuals and entrance of large foreign direct investments, in March 2007 the national currency continued to appreciate against the US dollar. If on 1 March the US dollar exchanged for 12.8040 MDL, then on 31 March the exchange rate reached the level of 12.5214 MDL/USD. The Euro exchange rate was more stable declining from 16.8905 MDL/Euro on 1 March to 16.7114MDL/Euro on 31 March 2007. We expect that in April the US dollar will vary within 12.4500 -12.6500 MDL/USD range.

In 2007 important changes will take place on the insurance market. Since in March the Parliament re-voted the law on insurance, for many operators on the insurance market began a hard time. According to the law's provisions, the insurance companies have to increase the social capital up to 15 million lei during 5 years, including up to 4 million lei in 2007. Currently, only 11 out 33 existent insurance companies have a social capital bigger than 4 million lei, while half of them do not reach the amount of 2 million lei. We consider that at least third of operators will leave the market in the next two years, either by merging or selling the assets to bigger companies. As a result, the market will consolidate, the quality of rendered insurance services will increase and the market attractiveness for western investors will rise. Moreover, the insurance companies ought to invest much more in advertisement and marketing campaigns to foster the insurance culture of the population.

Following a strong growth of the capital market in the first two months of 2007, in March the dynamic was moderately negative. This thing was proved by the stock exchange indices existent in Moldova. The main factor of a small stock exchange de-capitalization was the declining price on shares issued by Moldova-Agroindbank. Nevertheless, this dynamic is difficult to explain economically. The securities issued by the commercial banks remain the most quoted on the Moldovan stock exchange, holding around 4/5 of the stock exchange turnover.

Foreign trade

In the beginning of 2007 Moldova's trade balance continued to worsen. In February the trade deficit reached the level of 296.8 million USD, almost twice bigger than in February 2006. Thus, while during a year (02/07 comparing to 02/06) the exports rose moderately by 5%, the imports soared by 43.0%. The Moldovan citizens continue to be raven for consumption (see **Services**) that stimulates the imports even more. Behind these statistical tendencies, somehow common for the foreign trade in the last time, take place some distinct processes. Romania (and implicitly the European Union) has become in 2007 the main sales market for Moldovan exports. The exports to Romania grew, to a large extent, due to the prominent growth of the metals (12.3%) and other products (vegetal oil – 16.9%) share in the total exports. We have to mention that the increasing metal exports do not reflect a continuous trend in the dynamic of trade relations; it is rather a result of the statistical calculation reflecting the registration of Ribnița Metallurgical Plant at the Moldovan responsible institutions. However since March when the meat, fruit and vegetables exports to Russian Federation resumed, the Romania's supremacy could be moderated.

At the same time, the importance of the European Union as main sales market could consolidate even more, if the Autonomous Trade Preferences (ATP) are granted to Moldova. The process of negotiating the trade regime is on an "advanced" stage, as declares the Ministry of Foreign Affairs and European Integration, and the internal granting procedures have already started within the EU. The highest achievement for Moldova will be to include in ATP the "strategic" exports (wine and sugar) completely. A less optimistic outcome would be setting export quota for these products. Nevertheless, the full use of a preferential trade regime requires the compliance with all standards and norms stipulated by the European legislation. Unfortunately, despite some recent progress, Moldova's successes on this chapter are quite moderate (see **Business Environment**).

Despite the positive developments linked with the resuming of meat, fruit and vegetables exports, the situation with the wine exports return to Russian market continues to be uncertain. However, inspection visit by "Rospotrebnadzor" experts din not bring about concrete results, besides necessity to adopt ISO standards. Our expectations regarding resumption of Moldovan wine exports remain rather skeptical, influenced by a series of adverse negative political, trade and institutional factors.

The first months of 2007 produced some new reasons to be alarmed. The 'verbal' interdiction to export raw wine was the main culprit. These exports served for many exporters as saving straw, expanding by $10 mln. In 2006, while exports of bottled wines dropped. The interdiction provoked adverse reaction on behalf of Belarus, which along with Ukraine has become one of the main markets. Imports of bottled wines were imposed by Belarus authorities, depressing even more the troubled Moldovan wine-makers. Apparently, the issue is settled through establishment, in a rather murky manner, of a joint enterprise "Moldbelvin". This enterprise will become sole legal exporter of Moldovan raw wine to Belarus.

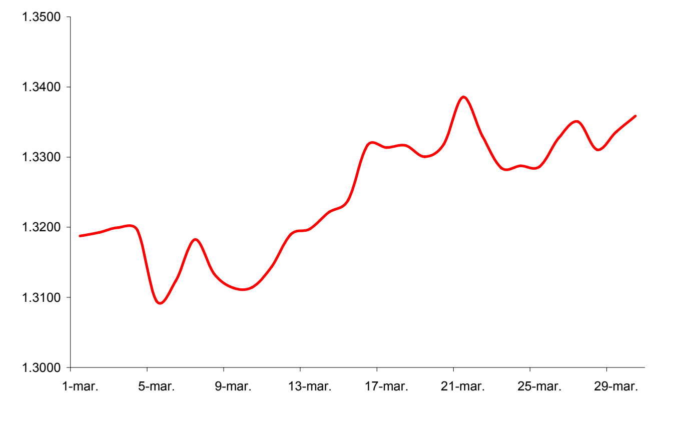
Developments in the wine sector are alarming. First of all, it is hard to understand lack of attitude by Moldovan authorities towards the sector's woes growing like a juggernaut. Up till now, this issue is not on the authorities' priority list, while officials are not in the hurry to establish a sincere dialogue with winemakers. Therefore, no feasible solutions for settling this issue are on the table. Secondly, the opacity of the regulation of the exports' resumption process and, most of all, the situation with raw wine exports in Belarus, make many experts to believe that interests and concerns of the winemakers and authorities diverge in opposite directions.

Global markets

By the end of March oil price (WTI brand) moved over $60 per barrel, fluctuating around $66. This trend is supported by two fundamental factors. Initially, US Energy Ministry announced the sixth consecutive reduction in commercial oil reserves. Then, the political tensions around Iranian nuclear dossier reignited with new vigor. Capture of the British marines strengthened these tensions even more. In the near future, global oil prices will be determined by the intensity of geopolitical risks.

In February-March 2007 the **wheat** prices declined on the American market, while rising in Europe. This trend was supported by shrinking supply and US dollar depreciation (a part of quotations is nominated in dollars). In mid-term perspective, developments on this market will be characterized by growth of production (US, CIS countries, EU and Australia), but also by growing demand in the non-producing countries. Thus, final stocks will remain at historical lows. At the same time, 2007 is expected to be marked by growth in global production of **barley** up to 150 mln. tons (+12 mln.) mainly due to expansion of plantations in EU and Canada[8].

Figure 7 Trends in euro/dollar exchange rate



Source: Rossbusinessconsulting

In March, 2007 a **dollar** experienced a significant slide against **euro** (Figure 7), trend that can be observed in

[8] Sources: USDA, World Agricultural Supply and Demand Estimates, Wheat Outlook; International Grains Council, Grain Market Report.

fluctuations of Leu against these currencies. The weakening of dollar was chiefly determined by softer economic activity data and necessity of correction of imbalances in American economy. Moreover, the IMF stated that weaker dollar would help to remove disequilibria in global economy.

Persistence of inflationary risks coupled with slackening economic growth undermine the vigor of the monetary tools at the Fed's disposal. At the same time, European Central Bank eyes interest rate hikes to put at bay inflationary risks associated with current perky growth in Europe. We expect these factors will support current trade of moderate depreciation of the dollar against euro in short term.

Trade partners

Russian economy expanded healthily in January-February 2007 (+8.%, y/y). The growth is strongly supported by strengthening of investment demans (+21.2%), constructions (+25,4%) and soaring consumption. The latter was suported by burgeoning real available incomes of population (+12.7%), including real wages (+17.5%). Salaries and incomes growth coupled with expanding consumption credit paved way for retail expansion by 13.9%. Inudstrial production was on the growing trend both in the extraction and procession sectors, +8.6%.

At the same time, the tendency of reducing the exports' contribution to the economic growth persists (see also **BER 17**). Moreover, the exports practically stagnated (+0.3%) due to the decrease of oil prices on the global market in January-February 2007. Spurred by the growth of real income of the population and the Russian ruble consolidation, the imports have increased considerably (+33.1%). The Russian ruble appreciation exerts more pressure on Russian producers, but offers more opportunities for the foreign ones. This tendency has to be fully exploited by Moldovan producers, especially the areas where the trade barriers have already been lifted.

In January-February 2007 the **Ukrainian** economy continued its strong growth, +8.6% comparing to January-February 2006. The growth was fuelled by some positive developments in industry (+14.4%) and constructions (+20.3%). The economic growth was firmly supported by the burgeoning consumption demand either. Retail sales along with the growing available income of the population (+12.8, 02/07 comparing to 02/06) increased by 25.9%.

Agriculture rose by 5.6% too. It is noteworthy that the Ukrainian government lifted the restrictions to barley and corn exports, but let in force those for wheat and rye exports. Maintenance of the quotas for wheat and rye exports will reduce the supply and will determine higher prices on the regional stock exchanges.

The end of March was marked by an escalation of a huge conflict between Yanukovich government and the governmental coalition, on one hand, and the Presidency and opposition, on the other. President Yuschenko signed a degree about the anticipated general election to Rada, while the parliamentarian majority doubts the constitutionality of this degree. Moreover, this conflict reflects closely the tensioned general situation within the political and economic elites. The conflict maintenance could undermine both the economic growth and Ukraine's joining the WTO.

Table 4 Economic indicators of the main Moldova's trade partners

	GDP		Industrial output,	Inflation,	Unemployment
	Last data	2007, prognosis			
Russia	8.4 01-02/07	6.3	8.6 01-02/07	2.8 01-02/07	7.3 02/2006
Ukraine	9.3 01-02/07	6.0	13.4 01-02/07	9.5 (yoy) 02/07	6.7 2006
Romania	7.7 2007	6.5	2.9 01/07	4.0 ian.07	7.3 02/07
Germany	3.7 2006	2.2	7.1 01/07	1.9 03/07	7.1 02/07
Italy	2.9 2006	1.7	1.3 01/07	1.9 (Euro zone) 03/07	6.7 T3, 2006

Sources: The Economist, IMF, World Bank, Derjkomstat, Goskomstat, Eurostat, INS România, EXPERT-GRUP.

The European Union continues to enjoy a positive economic trend. However, more pundits anticipate a moderate deceleration of the economic growth, mainly due to VAT rise in Germany and Italy, consolidation of the European currency and a cooling American economy. Moreover, after VAT was raised, the dynamic of retail trade was negative in January, but recovered marginally in February. Retail in "food, drinks and tobacco" declined in both Germany (-1.7%) and Italy (-2.1%, 01/07). This evolution will influence negatively the domestic consumption demand and consequently, the imports' dynamic.

On contrary, retail sales increased in Romania by 1.5% (01/07) and for "food, drinks and tobacco" even by 21.1%. Moldovan producers could exploit these tendencies after the ATP provision and the adjustment of Moldovan production to the European quality standards. According to the Romanian economic inquiries, a growth is expected in all 4 important sectors: industry, constructions, services and trade. This growth will be coupled with an increase of the number of employees (except industry) and salaries in these sectors.

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